Business rescue: UK vs US
Dispelling the myths of a ‘UK Chapter 11’

The US business rescue procedure Chapter 11 has enjoyed a raft of positive press coverage in the UK with many commentators calling for the UK to adopt a similar procedure. In this paper, we explore the benefits and drawbacks of Chapter 11. We conclude that although aspects of the process are appealing and could work well in the UK, Chapter 11’s “lock, stock and barrel” implementation in the UK would be a mistake.

What is Chapter 11?
In the US, a company experiencing financial difficulty - or its creditors - can file with the federal bankruptcy court under Chapter 7 or Chapter 11.

In Chapter 7, the business stops operating and a trustee sells its assets and distributes the proceeds to creditors. In most Chapter 11 cases, the original management continues to run the business as a ‘debtor in possession’, but all major business decisions must be approved by the bankruptcy court.

In most cases, the company will try to develop a plan to return to profitability and compromise with creditors at the same time. If a plan is not developed, the company is liquidated. The rescue plan has to be voted on by the creditors and stockholders, and confirmed by the bankruptcy court. Even if creditors or stockholders reject the plan, the court can still confirm the plan if at least one impaired class of creditors has voted to approve the plan and it concludes that the plan treats objecting creditors and stockholders in classes being “crammed down” fairly.

During the rescue, suppliers may be obliged to continue to supply to the company and, under certain circumstances, lenders who provide working capital to the company to finance the process may “leap frog” existing secured creditors if the company does eventually go into liquidation – i.e. they’re the first to be repaid out of the assets recovered.

A successful Chapter 11 is a restructuring rather than a liquidation. The idea is to give companies protection from creditors, under the supervision of the court, allowing them the much-needed breathing-space to restructure. In successful cases, jobs are protected and the value of business assets is retained.

What are Chapter 11’s advantages?

Chapter 11 appeals to company directors
Company directors in the US are willing to reach for Chapter 11 protection with a readiness that is alien to most directors in the UK. Under Chapter 11, the management continue to run the business - this factor leads them to seek advice at an earlier stage of financial difficulty which, in turn, usually results in a greater chance of long-term survival.

Super priority funding can facilitate restructure
During a Chapter 11 rescue, under certain conditions, lenders who provide funds to the company during the restructuring process can “leap frog” existing secured creditors if the company does eventually go into liquidation – i.e. they’re the first to be repaid out of the assets recovered. Super priority is widely accepted to encourage new (or existing) lenders to put money into the struggling company, which can dramatically increase the company’s chances of survival. R3 welcomes the idea of extending the availability of rescue finance like this in the UK, though there are technical difficulties which need to be thought through before it could be introduced.

What are the arguments against a ‘UK Chapter 11’?
Key criticisms of Chapter 11

The majority of Chapter 11s fail
In order to successfully reorganise, companies under Chapter 11 have to develop a re-organisation plan. Estimates suggest that somewhere between 17% and 33% of companies that enter Chapter 11 successfully confirm a plan of reorganisation. Research has found that more than half of companies in Chapter 11 do not produce a plan at all! The majority of companies that enter Chapter 11 do not come out the other side.

Chapter 11s can be slow and expensive
Chapter 11 is a court-driven process which involves setting up creditors’ committees. This process is both time-consuming and costly. Creditor groups/committees and other groups of stakeholders with a genuine interest in the assets are entitled to advice and representation at the expense of the Company. In the UK, most restructuring takes place outside formal insolvency processes or under the supervision of Insolvency Practitioners, making the process more flexible, faster and more cost-effective.

There is no time limit on Chapter 11 bankruptcies, so companies can be in them for...
Inadequate or incompetent management is a common reason for business failure. Chapter 11 allows directors who have presided over their company’s financial decline (failing to reverse the trend and even, in some cases, exacerbating it) to remain at the helm of the company through the restructuring.

A company in Chapter 11 is effectively operating under the “protection” of the court, which can give the company a significant advantage over its competitors, distorting the market and harming competing businesses. The US airline industry is a key example.

Chapter 11 isn’t the right solution for the UK

Chapter 11 isn’t suited to the UK’s business climate

The UK has a high number of SMEs – 99% of businesses are classed as small. Chapter 11 is open to companies of all sizes, but the process can be extremely expensive, and it is funded by the company. As a result, Chapter 11 is generally seen as the preserve of larger companies. Given the SME climate in the UK, a Chapter 11 model would do little to prevent the most widespread business failures in the UK.

The court system in the UK is not designed for Chapter 11

The court system in the UK would require dramatic modification to handle business restructuring in the US style. The process does not sit well with the experience and structure of the UK judiciary. Judges in the US are more commercially orientated than judges based in the UK. The court system here is adversarial rather than inquisitorial - i.e. courts in the UK do not “roll up their sleeves and get involved”, while in Chapter 11 they are directly involved in the decision making required to run companies, and sometimes even in the negotiations between the company and its creditors. It is one of the great glories of the UK system that our processes are driven by the business judgement of independent and accountable professionals, not by court process and procedural compliance.

Replicating Chapter 11 isn’t the silver bullet to US entrepreneurial culture

The US is widely thought to have an entrepreneurial culture, due to a combination of historical, economic, social and political factors – of which Insolvency laws are one element. If the UK were to replicate Chapter 11, we shouldn’t expect that our economy and business culture will, in consequence, mirror that of the US.

The UK is not ready for ‘super-priority’, which could give rise to unintended consequences

Super priority funding certainly has its advantages. However, it has proved to be quite contentious in the US, and banks in the UK have expressed concerns about the impact its introduction could have on lending. In the US, the law gives “adequate protection” to existing creditors to ensure that they are not unfairly ‘bumped down’ by new lenders – but there is ongoing debate over what “adequate protection” should entail in practice. The continual wrangling over this, as well as the way property rights are respected in the UK, suggests that adopting super-priority financing in the UK could be a real challenge.

The UK’s insolvency regime is “fit for purpose”

Our insolvency regime is envied abroad

The rehabilitative, progressive insolvency laws in the UK are envied by companies operating in many other jurisdictions. According to recent press reports, a number of international businesses consider relocating their management headquarters to England to give themselves, through access to UK procedures, a better chance of survival in the economic downturn than they would otherwise have: a phenomenon known as ‘bankruptcy tourism’.

The UK insolvency regime encourages entrepreneurship...

The Centre for Economics and Business Research produced a report on the UK insolvency system which concluded that “the UK insolvency industry plays a vital role in maintaining a business environment in which creditors are willing to lend, entrepreneurship is encouraged and the economy can flourish. Our research demonstrates that jurisdictions, like the United Kingdom, that treat creditors appropriately in times of business difficulties are the most likely to be prosperous in the longer-term.”

…and provides significant potential for rescue

The UK insolvency regime is not quite perfect, but it is full of useful and flexible procedures to help rescue businesses. A Company Voluntary Agreement (CVA), for example, is very effective at helping companies that are profitable in the long term to overcome a period of short term financial difficulty. Unlike Chapter 11, there is little court involvement - the CVA is under the control of a licensed and experienced Insolvency Practitioner who acts as a supervisor while the company’s management, sometimes strengthened, remains in post. Although there are tweaks R3 believes should be made to CVAs in order to encourage their take-up, the insolvency regime does provide great potential for company rescue.

Recession and early recovery is not the time to introduce wholesale changes

Making major changes to the UK insolvency regime during a period of recession or low growth would create uncertainty and could give rise to the law of unintended consequences, negatively impacting on Insolvency Practitioners’ abilities to rescue companies. Changing the insolvency regime during a time of recession or early recovery is also likely to unsettle lenders, which could damage businesses at a critical time. In recent years, there have been numerous changes to our insolvency regime - we need to let the “dust settle” in order to work out which aspects of the system are working well and which require adjustment before making further changes as a knee-jerk reaction to a challenging current economic situation.

Conclusion

There are certainly elements of Chapter 11 that are attractive, and aspects of the process the UK might do well to borrow. However, R3 believes that the serious flaws in Chapter 11, in conjunction with its incompatibility with our Court process and the UK business, lending and insolvency climate, renders a comprehensive ‘UK Chapter 11’ highly undesirable.

About R3

R3, the trade body for Insolvency Professionals, represents over 97% of Insolvency Practitioners. R3 members are trained and regulated accountants and lawyers who have extensive experience of helping businesses and individuals in financial distress.

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1 SME Statistics statistical press release, BERR, 30 July 2008